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MARKET COMMENT: ANOTHER UPWARD BLIP IN INTEREST RATES WEAKENS REALTY STOCKS

Right now the stock market has hit an air pocket and the Dow-Jones Utilities sustained one of their biggest one-day losses in history, all because some big money managers conclude that the downturn in interest rates is about over.

Real estate stocks in particular have been hit by rate concerns and by gloomy headlines on real estate's outlook (e.g., Thursday's Wall Street Journal article titled "Commercial Properties Encounter Hardships, Hurting Many S&Ls"). While concern focuses upon the S&Ls this time, the surfeit of office space we encounter in many Sunbelt cities may indeed spread leasing risks to some REITs. In this connection you should note our comments on New York City offices in the Rockefeller Center Properties offering review below, and on several recent REIT offerings in the July 26 issue.

Our market survey (page 4) shows all realty stocks off 2.0% since last issue, dead even with the Dow-Jones Industrials. Only the participating mortgage group rose, by 1.6%. Every other group fell, with major homebuilders off 9.3% and liquidating companies off 8.0%. Since Jan. 1, best performers

have been the realty service/syndicators (Group 10), up 27.2%, followed by preferred stocks (Group P), up 21.6%, and diversified realty/holding companies (Group 9), up 20.8%

Declines have run to 2-3 points for some. **UDC-Universal** fell 2 on a new unit offer partly to fund conversion to a partnership (RSR, July 26); **Centex Corp.** fell 3; **Bay Financial** 2; **Wells Fargo Mtg.** 2-1/2 on rumors of a proposed stock offering; and **American Century** 1-1/2 on collapse of a buyout. Hard-to-find winners included **IRT Property**, up to a new high on a 10.6% dividend increase and 5-for-4 stock split; and **Commonwealth Realty**, up 9%.

Is it time to sell? We think not. In the past such pauses have always evoked a lot of hand-wringing but have turned out to be buying opportunities.

NEWS OF REALTY STOCKS: ROCKEFELLER CTR. OFFERING PLAN CAPTURES MARKET SPOTLIGHT

Not since Chase Manhattan Corp. sponsored a REIT nearly 15 years ago has a new REIT offering captured so much market attention as the planned \$1.1 billion offer of **Rockefeller Center Properties, Inc.**

Now bigness is a questionable vir-

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tue in some real estate deals. But beyond bigness, the proposal calls for examining two visceral questions surrounding REIThood: Should public investors own real estate? and, Is the public a buyer of last resort?

The proposed offer: RCPI plans offering \$600 mil. of common shares (30 mil. shs. at \$20) inside the U.S., which will be leveraged by \$500 mil. of debt, including \$335 mil. current-coupon convertible debt and \$165 mil. net amount of zero-coupon convertibles, both to be sold outside the U.S. The zeros will be sold at about 22.6% of par. Both debentures will be convertible only during the 15th year, or the year 2000; if both issues fully convert, they would own a combined 67.4% of RCPI -- in 15 years.

RCPI will use proceeds to fund a \$1.1 bil. participating mortgage loan to two partnerships owning Rockefeller Center; the loan is convertible into 60% ownership of the Center in 2000. Loan interest is 7.34% initially rising to 8.43%; base interest will exceed net cash flow from the property in seven years before 1995 by \$148 mil. total. The borrower is putting up a \$300 mil. standby letter of credit to support this negative cash flow. The loan carries additional interest on Center revenues over \$325 mil., not expected before 1995, after low-rent leases, mainly to NBC, on 47% of space expire in 1994 and presumably roll to market rents.

In 1986 the common will get an estimated \$1.75 payout, or 8.75%, from funds available for distribution; about 26% (41¢) may be tax-sheltered amortization of discount on the zeros. What happens in the subsequent 14 years depends upon an investor's view of future inflation, and the prospectus gives investors future dividend estimates based upon three views of inflation -- 4%, 6%, and 8%. By making formal operating projections for varying inflation assumptions, this offer thus resembles the EQK Realty offering (RSR, Mar. 22).

These projections assume that distributions in some early years will be supported by the letter of credit, and

that distributions in 1995 and beyond (estimated at \$3.75/sh. in 1995 rising to \$5.11 in 2000) will be bolstered by additional or kicker interest after low-rent leases are upgraded to market. This means about 80% of estimated stock values derive from dividends and 20% from residuals.

Analysis of two criticisms:

Criticism 1: The 6% inflation assumption (around which most projections revolve) is aggressive. We've long observed that leveraged real estate tends to outperform inflation whatever inflation happens to be. Put another way, it's not necessary to make a correct inflation assumption to come out ahead in a real estate investment.

Applied to Manhattan real estate, our experience is that office rents have inflated at about 9% compounded over the past 15 years -- including a downturn of about 8%-10% the past three years. Midtown Manhattan office vacancy of 5.3% now is the lowest among all major cities and compares to vacancies running to 20% or more in some Sunbelt cities. Vacant space is about a two-year supply now, vs. much higher ratios elsewhere. Rockefeller Center has a 1.6% vacancy rate at \$26.50/sq. ft. average rents, or about two-thirds the going \$40 rate.

Criticism 2: The price is rich. Rockefeller Center is appraised at \$1.6 bil. now, or about \$259/SF for the 6.2 mil. net rentable SF. This is below the \$299-\$330/SF prices in three recent major Manhattan office sales (245 and 270 Park, 85 Broad) and below the \$400/SF price of the Crocker Center in San Francisco.

The 60% interest being offered is thus worth about \$960 mil., to which we would add the current value of the letter of credit guarantees and the residuals estimated at \$200-\$230 mil., or total value of about \$1.2 bil.

So back to our original questions: Is the public a buyer of last resort? On price alone, the public appears to be getting equal treatment with major institutional buyers of other landmark

properties. Perhaps more to the point, inflation has carried aggregate prices of landmark properties to such heights that only major public vehicles (such as REITs) can raise enough funds to be effective buyers. Should public investors own real estate? With adequate disclosure of risks, the combination of yield, liquidity and capital gains is hard to beat.

RANKING REVIEWS: PRESIDENTIAL REALTY UPGRADED; JOHNSTOWN AMERICANS NEW DEAL

Presidential Realty Corp. rises to B Rank because of improved liquidity, dividends, and cash flow. The White Plains, N.Y. REIT has sold most properties over the last two years for purchase money mortgages; the deals let buyers benefit from depreciation and other taxable losses while improving PDL's interest income. Subgroup Ranks:

EPS/Dividends - B. Operating EPS rose 26% to \$1.22 primary in 1984, and PDL reported \$1.39/sh. gain on property sales for total EPS of \$2.61. Operating EPS rose 31% in the six months to June to 72¢, plus 4¢ sale gains. Dividends were boosted several times in recent years, rising at 37% annually to a current 92¢ rate, so that PDL is paying out operating EPS while retaining gains.

Financial measures - B. Debt totals \$23.2 mil. but over half (\$13.2 mil.) is related to properties sold, leaving \$10.0 mil. corporate debt about equally divided between secured mortgages and unsecured convertible debentures. Corporate debt is 4.4 times the \$2.3 mil. book equity under general accounting principles but 0.26 times adjusted tangible net worth as defined by lenders. This item totals \$38.5 mil. or \$11.84/sh. and includes book equity plus \$3.6 mil. accumulated depreciation and \$32.7 mil. deferred gains on sales, less intangibles. PDL holds \$74.6 mil. face amount of mortgages and notes receivables on properties sold supporting and wrapping around the \$13.2 mil. debt. Deferred gains (\$32.7 mil.) and valuation reserves (\$20.9 mil.) reduce receivables to \$20.9 mil. net carrying value. Receivables include \$7.3 mil. gross and \$2.8 mil. net loans to a related party, Ivy Properties Ltd., which converts New

York City area apartments to coops. Receivables now generate about \$4.3 mil. annual interest income as liquidity.

Exposure - B. PDL has improved its position by (1) converting to REIT status, and (2) selling properties (mainly older FHA-financed apartments) on favorable terms that improve income and cash flow. This accounts for strong price appreciation in the shares (Class A, \$14.00, up 24% since Jan. 1; Class B, \$11.50, up 29.5%). Shares are identical except Class A elects 2/3 of the board.

Johnstown American Cos. (\$9.75--ASE) maintains B Rank on a pro forma basis following its acquisition of Consolidated Capital Cos., California based major syndicator and sponsor of four REITs with about one-eighth of REIT industry assets. JAC paid \$150 mil. for ConCap in July, consisting of \$75 mil. cash, \$25 mil. of 12% notes due in one year, and 500,000 new JAC \$8 preferred convertible into 8 common (or 4 mil.) shs. after three years. The acquisition adds ConCap's management of about \$2 bil. real estate assets to JAC's growth in direct property management.

EPS/Dividends - A. On a pro forma basis JAC's revenues would about triple from \$55 mil. for its Aug. 1984 year to \$161 mil. EPS, which have grown at 43.5% compounded over the past four years, would be diluted by 5%-8%: from 62¢ to 59¢ in Aug. 1984 year and from 36¢ to 33¢ in six mon. to Feb. '85. We expect JAC to report about 75¢ for its August, 1985 year, with the fourth quarter down a bit. Fiscal 1986 should be much better as ConCap is integrated into JAC, with estimates running \$1.05 to \$1.25/sh. The acquisition has added more volatility to JAC's earnings, mainly because ConCap's big swing factor in profitability is property acquisition and mortgage commitment fees, which are related to real estate markets. JAC dividends have risen to 30¢ annual rate since resuming following acquisition of Hamilton Invest. Trust in 1983.

Financial measures - B. Total debt of \$114.4 mil. is 1.8 times total preferred and net common equity of \$64.7 mil. Debt includes \$50 mil. bank loan and \$25 mil. deferred purchase notes related to the ConCap acquisition, plus

\$35 mil. 9.75% debentures convertible at \$11-5/8 per share. Liquidity seems adequate following the transaction, and with about 91% of debt classed as long-term, matching with assets is good. We compute net common equity at \$1.33/sh. net of \$50 mil. preferred liquidating value. Fully converted equity would be \$5.53/sh. Our calculations do not deduct \$132.6 mil. (or \$12.05/sh.) goodwill arising from the acquisition.

Exposure - B. JAC has taken the lead in trying to consolidate and modernize the highly fragmented local property management business. The risk is that it has acquired many local service businesses without large tangible assets other than personnel. So far JAC has experienced several notable successes and a few disappointments; it writes off most acquisitions over 8 years, so that the balance sheet won't be cluttered by heavy goodwill. In acquiring ConCap it is buying into an asset management business whose principals are well known, since JAC has managed most ConCap apartments for years. The acquisition thus eliminates any doubt about potential conflicts between the two, and the \$132 mil. goodwill will be written off over 24 years (i.e., about 47¢ sh.). Voting control is held by Chrm. John Lie-Nielsen thru Cl. B shares with 82.5% vote.

Health Care REIT Inc. (\$24-7/8--ASE) holds A Rank by continuing earnings and dividend gains. HCN also has been one of 1985's bright stars among REITs, rising 26.9% since Jan. 1. HCN specializes in financing nursing homes and is now entering retirement centers. Based in Ohio, it operates in 11 Midwestern

and Southwestern states. HCN typically finances construction thru leasebacks providing rent at about 14% initially escalating at 2%-3% yearly, and with a repurchase option after five years also increasing at 2%-3% yearly.

EPS/dividends - A. EPS have been growing at 7% annually over the past five years, and reached \$2.57/sh. in 1984 (before a 3-for-2 stock split effective Sept. 3). HCN's leases build in some capital gains which amounted to 22% of \$1.96 dividends in 1984 and has averaged 22%-30% the past three years. Dividends are less than reported EPS because of differences in tax and book treatment of leases; the difference effectively lets HCN retain some income.

Financial measures - A. HCN debt of \$67.5 mil. is about 1.6 times equity of \$41.3 mil. or \$14.73/sh. This reflects Nov. 1984 sale of 862,500 new shares. HCN is now discussing selling \$10 to \$20 mil. convertible debentures. The operating plan is to sell new stock or debentures when the debt/equity ratio reaches 3-to-1. As noted, HCN can retain some earnings which amounted to \$2.40/sh. at March 31.

Exposure - A. HCN has not been a flashy corporate acquirer but has concentrated on knowing a specialized business very well. It is now venturing into financing retirement centers, where costs are higher than the \$22,000 average cost of a nursing home bed. It is gearing units for retired public servants who can afford \$1,000/mon. rents. The first center opened recently in Toledo, O., and six others are in planning. HCN management has ties to a subsidiary of Owens-Illinois Co.

COMPARATIVE REALTY STOCK GROUP AVERAGE 8/6/85

GROUP NUMBER & NAME	DIV	NON-DIV	TOTAL	SHARE (000)	BOOK VALUE	ANN DIV	EARN ANN	LAST PRICE	-% CHNG FROM JUL 23	FROM JAN 1	P/E RATIO	ANN YIELD	% PR TO BK	RETURN ON BK	MARKET VALUE
1 PROPERTY REITS	32	5	37	4571	11.59	1.17	1.19	15.95	-1.1	8.9	13.4	7.4	137.6	10.3	2859.7
2 PROP & MTG COMB REITS	16	2	18	4790	13.41	1.48	2.13	18.73	-1.5	0.1	8.8	7.9	139.7	15.9	1738.8
3 MORTGAGE REITS	13	1	14	6066	12.75	1.68	2.55	16.53	-0.1	7.9	6.5	10.2	129.7	20.0	1489.7
4 PARTICIPATING MTG REITS	8	3	11	5041	11.76	0.64	0.59	13.42	1.6	2.5	22.9	4.7	114.1	5.0	645.5
5 MAJOR HOMEBUILDERS	8	1	9	14990	11.19	0.33	1.24	16.66	-9.3	8.7	13.4	2.0	148.9	11.1	1898.1
6 OTHER BLDRS/DEVELOPERS	9	26	35	4978	5.52	0.05	0.23	8.28	-3.6	17.7	36.0	0.6	150.1	4.2	1454.0
7 INCOME PROP BLDR/OWNR	12	9	21	6089	8.86	0.52	0.86	15.90	-0.4	8.9	18.6	3.3	179.6	9.7	2505.8
8 MORTGAGE BANKER/FINANCE	7	6	13	10098	8.54	0.67	0.47	13.71	-2.7	16.0	29.1	4.9	160.7	5.5	2526.4
9 DIVERSIFIED RLTY/HOLDING	12	10	22	18442	12.26	0.26	1.05	18.54	-1.6	20.8	17.6	1.4	151.3	8.6	11098.5
10 RLTY SVCS/SYNDICATOR	6	2	8	5920	5.97	0.11	0.92	10.66	-4.9	27.2	11.6	1.0	178.4	15.4	472.0
11 MANUFACTURED HOUSING	3	8	11	10943	5.28	0.11	0.11	7.73	-4.8	-17.1	70.3	1.4	146.4	2.1	1009.0
P PREFERRED STOCKS			3	2650	8.83	0.80	0.00	12.21	-3.6	21.6	NC	6.6	138.2	NC	93.1
L LIQUIDATING COS			3	8081	10.14	6.86	19.48	5.25	-8.0	-40.5	NC NC		51.8	NC	91.8
OVERALL AVERAGE			205	7725	9.77	0.66	1.00	14.25	-2.0	9.6	14.2	4.7	145.9	10.3	27882.4
DOW JONES INDUSTRIALS							107.87	1325.16	-2.0	9.4	12.3	4.6			

NOTE: LIQUIDATING COMPANIES AND PREFERRED STOCKS INCLUDED ONLY IN COMPANY AND MARKET VALUE AGGREGATES; NOT INCLUDED IN OVERALL AVERAGE